ARA response to Productivity Commission inquiry

COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

MARCH 2018

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Productivity Commission

Competition in the Australian Financial System Inquiry

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ARA Response to Productivity Commission Inquiry:

Competition in the Australian Financial System – Draft Report

March 2018

About the ARA:

The Australian Retailers Association (ARA) is the retail industry's peak representative body representing Australia's $310 billion sector, which employs more than 1.2 million people. The ARA works to ensure retail success by informing, protecting, advocating, educating and saving money for its 7,500 independent and national retail members, which represent in excess of 50,000 shopfronts throughout Australia. The ARA ensures the long-term viability and position of the retail sector as a leading contributor to Australia's economy.

Members of the ARA include Australia's most trusted retailers, from the country's largest department stores and supermarkets, to specialty retail, electronics, food and convenience chains, to mum-and-dad operators.

Executive Summary:

The ARA runs the Australian Merchant Payments Forum (AMPF) on behalf of Australia's retail merchants to advocate competitive, innovative and consumer-friendly payment options for the retail sector. The AMPF are the only merchant payments-specific industry body in Australia and directly consults with and consists of retail merchants.

Together, the ARA and AMPF represent the interests of merchants within the payments sector of the economy. It is important that the perspectives of retailers and merchants are considered in addition to those of schemes, issuers, acquirers and cardholders. Merchants invest in payments infrastructure and are an essential component of the payments system.

The structure of the retail sector, along with the financial sector, has shifted and evolved as a result of globalisation, advances in the digital economy and changes to business practice policies. While Australia's financial sector remains unquestionably strong, the retail industry has faced significant challenges over recent years. Costs and competition are two of the most significant issues, which permeate all aspects of retail business operations.

The ARA and the AMPF welcome the opportunity to respond to the Productivity Commission's (PC) *Inquiry into Competition in the Australian Financial System: Draft Report* (the report). This Inquiry is welcomed by retailers, who face significant challenges at a time when the financial and payments systems are evolving rapidly. Our submission focuses on payments and the payments system, which are of primary concern to retailers.

1: The High Price of Innovation - Reducing card routing costs:

Retail merchants operate in an age of payments innovation, where convenience and technology dominate. However, the ongoing costs of meeting consumer expectations are a high price to pay for many retailers. Payment costs remain an ongoing burden for retailers competing in the face of overseas and online merchants and changing customer expectations. While these cost pressures extend across retailers of all sizes, SME retailers bear a heavier burden in relative terms due to their respective lack of economies of scale.

Contactless payments technology, specifically through 'tap-and-go' debit card transactions are one key cost driver for Australian merchants. 63% of payment cards in Australia are dual-network cards (DNCs), co-branded with eftpos and the major card schemes, Mastercard and Visa[1]. Cards which feature contactless technology

[1] RBA 2016, 'Dual Network Cards and Mobile Wallet Technology' consultation paper.

are automatically routed through the major schemes, which are at a higher cost[2] than the eftpos alternative. This represents a technology lockout which removes choice for consumers and merchants, increasing the difficulty of managing costs associated with differentiated payment methods and networks.

Maintaining consumer and merchant choice across all payment channels and environments is critical for competition and payments innovation in the retail industry. Retailers are facing increasing transaction costs due to a lack of choice for contactless, dual-network card payments. One estimate placed the figure at $558 million per annum in extra costs to local retailers[3]. These costs are ultimately passed on to consumers through higher prices for goods and services. Currently, the competitive environment within the financial industry has been such that merchants have faced barriers to accessing low-cost alternatives when routing contactless payments[4].

We argue that eftpos can support contactless payments while delivering low merchant fees. While eftpos capability for contactless payments did not exist at the time of their inception, the major schemes in Mastercard and Visa now dominate the market through their relationships with issuing banks. Because of the lack of investment in contactless payments and routing in the past, we have seen exponential growth in the practice of debit routing via the schemes and a collapse in the low-cost alternative.

With two thirds of all card payments processed at Point-of-Sale (POS) in Australia now contactless[5], the ARA and AMPF are continuing to advocate for least-cost routing for Australian retailers. In December 2017, the House of Representatives Standing Committee on Economics advised in its third report into the *Review of the Four Major Banks*, that least-cost routing should be made available to merchants by 1 April 2018. The Committee recommended that the Reserve Bank of Australia (RBA)

[2] RBA 2017, 'Merchant Payment Costs and Least-Cost Routing' speech, December 2017.
[3] BankingDay 2017, 'Banks extra sensitive on merchant fees' article, 20 November 2017
[4] Ibid
[5] RBA 2017, 'How Australians Pay: Evidence from the 2016 Consumer Payments Survey'.

take action on least-cost routing should the major banks fail[6] to do so. Outside of media releases, little has been done to progress least-cost routing at the time of writing, with 1 April fast approaching. The ARA and AMPF call on the PC to advocate least-cost routing in its final report and will explore regulatory intervention to move ahead with lowering costs for merchants and consumers alike.

2: The 'Interchanged' v. the Unregulated:

The ARA and AMPF do not fully support the PC's recommendation to ban interchange fees by mid-2019. We believe, foremost, that banning interchange will inevitably lead to cost shifting by payments providers, which will have adverse impacts on consumers and merchants alike.

The ARA and AMPF have previously supported a ban on interchange fees. However, this position was formed in an environment where cash was still the dominant form of payment and where card payments had not yet reached reasonable market saturation. In the intervening period, significant innovations have been made in the payments space, including chips in cards, the abolition of signatures, contactless payments and mobile wallets, to name a few. Thus, the case to remove interchange fees on cards in order to remove barriers to access no longer needs to be made.

Given the significant complexity of scheme costs and other merchant fees, the potential for cost-shifting is high. Banning interchange fees on card payments will likely lead to increases in costs elsewhere on the fee spectrum, which may ultimately have unintended cost consequences for both merchants and consumers.

Further, under the RBA's interchange regime, interchange fees on cards could only be banned for regulated 4-party schemes, which includes eftpos, Visa and Mastercard, issued by Australian-based financial institutions[7]. Unregulated 3-party schemes, especially American Express (Amex), Diners Club, and 3-party scheme China

[6] House of Representatives Standing Committee on Economics 2017, 'Review of the Four Major Banks (Third Report)', Parliament of Australia.
[7] RBA 2016, 'Review of Card Payments Regulation: Interchange Fees and Transparency of Card Payments'.

UnionPay (among others) do not fall under the current interchange regime due to their status as 'foreign-issued'. This is despite their significant and increasing market share in terms of total dollar value and percentage overall spend in Australia. The RBA has previously signalled concerns about the prospect of circumvention of Australian regulation by foreign issuance.[8]

The PC notes in its draft report that '*interchange fees can be used to fund benefits offered to the customers, such as rewards points. Rewards programs can make up to a quarter of the overall costs of issuing credit cards…*[9]' Retailers are concerned that a ban on interchange fees may lead to 4-party schemes removing incentives for customers, triggering a shift toward unregulated 3-party schemes. This amounts to problem shifting, ultimately increasing costs for merchants and consumers alike.

2.1: 3-party scheme regulation:

Consumers in Australia are already utilising 3-party schemes in ever-increasing amounts. The majority of 3-party schemes can be classified as foreign-issued, and as such, do not fall under RBA regulation[10]. This has been exacerbated by recent practices from issuers under 'companion card' arrangements, which link 3-party cards such as Amex together with a 4-party 'companion' card. Consequently, retailers are facing growing usage of these high-cost payment products.

Cardholders choose these cards to retain the loyalty and other benefits offered by 3-party card schemes. This means that an increasing number of Australian retailers are processing high amounts of unregulated international cards through their businesses. This has extended beyond the traditional schemes such as the ubiquitous Amex and Diners Club to include China UnionPay (the only unregulated 4-party scheme), JCB and others.

This is an element of Australia's payments systems regulation which continues to lack. While it is clear that the RBA does not exercise jurisdiction over international schemes, it should be reasonable to assert that the RBA ***does*** exercise jurisdiction

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[8] RBA 2016, 'Review of Card Payments Regulation: Interchange Fees and Transparency of Card Payments'
[9] PC 2018, 'Competition in the Australian Financial System: Draft Report'.
[10] Ibid

over the application of international interchange fees and the operation of such schemes through Australia’s payments architecture.

Historically, inaction on the costs of such schemes has continued to frustrate the establishment of a level playing field in Australia’s payments market. While the costs of such schemes are prohibitive, merchants often have little choice but to wear the costs or lose business. This severely undermines the intentions of the RBA, PC and others in fostering an efficient, transparent, and innovative payments system. The ARA and AMPF believe a focus should be laid on removing barriers to newer innovations in the payments space, including uptake of digital wallets, contactless and wearable payments devices. We are calling for the PC to recommend regulation of 3-party schemes in Australia.

3: Innovate or Perish:

The PC highlighted in its report the importance of purchased payment facilities (PPF) in stimulating competition for incumbent payments providers. The ARA and AMPF are excited about innovations in the payments space. For retailers, mobile wallets can improve and simplify the payment experience, while creating the opportunity to deepen the relationship with customers. For customers, they have the potential to make life simpler and more convenient by combining payment cards, loyalty cards, identification, public transport cards and more into one device.

Members of the ARA and AMPF see innovation potential for the very small retailer through to medium and large businesses. Restricted access will stop those opportunities from occurring. However, these benefits will not be achieved unless consumers and merchants have a choice between mobile wallets and mobile payment services whichever mobile device or platform they have chosen to use.

The ARA and AMPF supported a recent application by the ACCC to collectively bargain with Apple in order to drive payments innovation through ApplePay. This was blocked by the ACCC, and the barrier to NFC technology on Apple products continues to stifle payments innovation in Australia.

If NFC access were available on Apple products:

- Customers could pay for their purchases and earn or redeem reward points using a retailer's mobile wallet, an issuer's mobile wallet, or an open mobile wallet as they preferred, and with an equal level of convenience to the mobile wallet pre-installed on their phone.
- Retail staff and even sole traders could use iPhones as portable mobile payment terminals capable of accepting contactless NFC payments.
- Retailers could add NFC tags to their shelf label systems for customers to scan for product information – for example, a customer with particular dietary requirements or allergies could quickly scan a shelf label with their mobile wallet and be alerted of any relevant product ingredients; other customers might scan a label for product specifications and reviews or to check items off an electronic shopping list which has been populated by their mobile wallet.
- Retailers, airlines and other merchants with 'member only' areas or lounges could use the NFC function on smartphones as an authorised access system, available only to the relevant sub-set of their clientele.
- Hoteliers could use the NFC function to provide immediate room access to through customers or loyalty club members availing themselves of pre-arrival check-in, permitting them to by-pass any potential queue at the front desk.

Mobile payments will continually and significantly impact the ability of merchants to choose the payment network that best suits their needs. In a mobile world, only one scheme application will be observable to the consumer or merchant/acquirer for any given transaction, eliminating any existing network choice that they may have. Without open competition in consumer payments and a viable domestic payment network which is freely able to compete on a level playing field with its contactless and mobile products, interchange rates, merchant fees and consumer costs may rise.

While innovations in other areas of the payments space have increased competition and convenience for consumers, they have outpaced regulation thus far. Patchy regulatory oversight has led to inconsistencies in payments innovation in Australia. The PC highlighted in its report a regulatory gap which exists between the RBA and the Australian Prudential Regulation Authority (APRA). Where the RBA is responsible for payments architecture and APRA is responsible for financial services providers –

an unforeseen gap in regulation has allowed some PPFs to continue unmoderated. PPFs such as PayPal fall under strict regulation, while AliPay and WeChat do not. This lack of regulatory oversight could lead to unintended consequences for consumers and merchants alike.

In any market, efficiency and cost effectiveness are achieved through scale; the payments market is no different. Innovation depends on scale for success, which is where traditional incumbents such as Mastercard, Visa and PayPal have had the advantage. This has allowed smaller players, such as AliPay and WeChat to escape regulation through their lack of scale, while delaying fair competition in the payments space through prohibitive costs and technology lockout for both consumers and merchants.

Regulation of payments schemes assists in minimising confusion and maximising adoption, through mandating common standards, minimising scheme rule conflicts, and reducing barriers to access from prohibitive licensing and pricing costs. This paradigm often arises from innovation outpacing regulation, with recent examples including NFC technology, mobile wallets and DNCs.[11] The ARA and AMPF are advocating for the ePayments Code to be mandated as a minimum requirement for all PPFs entering into the Australian payments market. This will assist in achieving a more consistent and transparent approach to payments innovation in the Australian landscape going forward.

4: Payments Fraud:

With innovation comes a degree of risk, and card-not-present (CNP) fraud continues to proliferate as an issue for retailers and merchants. The Australian Payments Network (APN) estimated the cost of CNP fraud in 2016 at $417.6 million, out of a total of $533.8 million in overall card fraud. On these figures, CNP represents 78% of the total fraudulent transactions on Australian cards.[12] The growth of online retail has contributed significantly to the rise in CNP fraud during the last decade.

[11] APRA 2017, 'APRA Insight Issue Four 2017'.
[12] Australian Payments Network 2017, 'Australian Payments Fraud 2017 Jan-Dec 2016 Data'.

Comparatively, most recent estimates place CNP fraud in overseas jurisdictions at 66% for the European Union (EU) and 69% for the UK.[13] As other jurisdictions begin to implement technology to tackle fraud, there is a risk that this figure will escalate as fraudsters will begin to more-frequently target Australia. Overseas, the European Banking Authority is implementing moves to tackle CNP fraud in 2018 while in France, regulations on CNP fraud mitigation have led to an adoption rate of 60% for online merchants[14]. Australia's attractiveness as a destination for fraudsters and cyber criminals will only increase if action is not taken at home.

Card-present fraud, by comparison, has dropped significantly in recent years due to innovations such as chip technology and the removal of signature authorisations for card payments in 2014. The ARA and AMPF were highly involved in the 'Pin-not-Sign' campaign, which was a key measure in increasing card-present payments security.

We are advocating for a mandated and industry-led implementation of 2-factor authentication to assist retailers in tackling fraud online. This would include extra-authentication steps for consumers who do not satisfy specific data requirements when making a purchase. In 2016, the ARA and AMPF supported an Australian Payments Clearing Association (now APN) application to the ACCC to mandate the implementation of 3DSecure across the merchant industry, along a risk-based approach. The ACCC rejected this application, and CNP fraud has nearly doubled in the intervening period from an estimated $99.1 million in 2014 to the current $175.6 million estimate[15].

While fraud-detection technology such as 3DSecure version 2 (3DSv2) exists, the costs of implementation are prohibitive, especially for SME retailers. Retailers are looking towards implementation of a mandated system which meets minimum security requirements of the financial providers. In doing so, this will achieve a shift of liability away from retailers, a key competitive measure. SMEs incur significant losses from CNP fraud, which are often not recoverable from financial providers.

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[13] US Payments Forum 2017, 'Card-Not-Present Fraud around the World'.
[14] Ibid
[15] Australian Payments Network 2017, 'Australian Payments Fraud 2017 Jan-Dec 2016 Data'.

Subsequently, this also acts as a significant deterrent to SME retailers looking to establish an online presence.

The ARA is supportive of moves signalled by APN to again push for a broader implementation of CNP fraud mitigation, likely through 3DSv2. However, we are cautious about the application of measures which are not mandated across industry. A non-mandatory approach may leave some retailers at a competitive advantage or disadvantage, depending on the implementation of any such scheme. The ARA and AMPF believe that a mandatory, industry-led CNP fraud mitigation system will ensure a consistent consumer experience across all e-commerce retailers, ensuring no retailer is competitively disadvantaged.

We are seeking leadership from Government and regulators in implementing these measures. An industry-backed, flexible approach will ensure that SME retailers are more able to detect and prevent instances of fraud at a lower cost. This will also ensure that all consumers will experience a consistent approach, preventing market failure from fear of dropout or migration to other competitors.

Summary:

Australia's payments system has traditionally led the world in innovation, ease of use and access. However, to stay ahead of the curve, important changes should be made to level the playing field, foster innovation and improve competition for the benefit of both consumers and merchants.

The ARA and AMPF recommend that the PC in its findings should recommend the following to improve the competitiveness of payments in Australia:

- The RBA should regulate to allow merchant choice for least-cost routing on DNCs.
- As a pre-curser to banning interchange on card payments, the RBA should move to regulate foreign-issued 3-party schemes to reduce costs for merchants.
- Mandatory application to the ePayments Code for all PPFs to ensure a level playing field and bridge the regulatory gap.
- Continued leadership from regulators to improve access to innovative payments technologies such as NFC and mobile wallets.

- An industry-led mandate for CNP fraud mitigation systems to defend against payments fraud and shift liability away from merchants.

The ARA, AMPF and our members are grateful for the opportunity to assist the PC with its inquiry. For further information or comment, please contact policy@retail.org.au.

Kind regards,

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